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Globalization and Decentralization: The Gains from Open Domestic and International Trade

Globalisasi dan Desentralisasi: Keuntungan dari perdagangan Domestik dan Perdagangan Internasional yang Terbuka

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Globalization and Decentralization: The Gains from Open Domestic and International Trade[1]

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One of the clearest stylized facts of modern economic growth is that it has been accompanied by the growth in international economic transactions, particularly the volume of international trade.[2] Historical data indicate that world trade volume (measured by exports) has risen relative to world production from under two per cent in the early 19th century to about 15 per cent today (Madison 1995 and 2000). During periods of prosperity the ratio of trade to production has risen and in periods of depression and war it has fallen. For example, between 1820 and 1929 the ratio of trade volume to GDP rose from less than 2 percent to 9 percent, but fell off to about 6 percent as a result of the Great Depression, World War II and the widespread adoption of protectionist policies amongst developed countries. It is demonstrably true that the strengthening of the global trading system has facilitated the remarkable period of growth and prosperity since the end of the Second World War.

The lowering of protective barriers to international transactions under the GATT/WTO, at the regional level and through unilateral reform, particularly in developing and transitional economies has eased the flow of international trade and investment. The consequent rise in trade volume brought about by this process of liberalization has delivered unprecedented gains to developed and developing countries alike. In addition to trade and investment liberalization, rapid technical progress, improvements in transport and telecommunications infrastructure and the expansion of multinational enterprises have contributed to increased international trade in goods and services. And while this expansion of international economic activity, often associated with "globalization" has been asserted to be a dominant trend, in reality it is more modest when measured against domestic trade and economic activity. For example, take the market share of imports of manufactured goods in the apparent consumption of manufactures in the two largest economies in the world. In Japan imports' share in consumption of manufactures increased from 6% to 9.6% between 1988 and 1997, while in the US case the rise was from 14% to 17%, hardly earth-shaking numbers.[3]

It is worth emphasizing that domestic trade and production remains the most important share of economic activity despite globalization. This so-called *home bias* is reflected in studies of trade between states and provinces across one of the most open borders in the world, that

[1] This paper was presented at a Conference on Domestic Trade, Decentralization and Globalization at the Hotel Borobudur, Jakarta, Indonesia, on April 3, 2001, which was co-sponsored by the Partnership for Economic Growth (PEG), the United States Agency for International Development (USAID), and the Ministry of Industry and Trade (MOIT), Republic of Indonesia (RI). PEG is a USAID-funded project with the RI. The views expressed in this paper are those of the author and not necessarily those of USAID, MOIT, or the U.S. Government.
[2] This section of the paper is drawn partially from James (2001).
[3]It would be desirable to add the domestic sales of manufacturing affiliates of foreign MNCs to imports to get a full picture of the share of foreigners in domestic manufacturing consumption. However, in many cases such sales are substitutes for imports (as in the case of Japanese automobile affiliates in the US). This may be one reason for an observed decline in the market share of imports from Japanese manufacturers in the US market between 1988 and 1997, from 3.25 to 2.68 percent (James and Movshuk 2000).

which separates the whole of continental Canada and the lower 48 states of the United States. Trade flows across the US-Canadian border are amongst the freest in the world. Since 1989 the two countries have implemented a Free Trade Agreement that is comprehensive and that has fostered a surge in cross border trade flows. Despite this, empirical analysis of inter-provincial trade flows within Canada reveals that such flows remain many times as dense as the trade that flows across the border to the United States in 1996 despite the FTA (McCallum 1995 and Ceglowski 2000).[4] Again, this suggests globalization cannot eliminate the tendency to home bias in trade and economic activity.

Foreign direct investment (FDI) is also often cited as a major facet of globalization, but FDI rarely exceeds a tiny fraction of national fixed capital formation and is rarely more that 5% of annual domestic investment. Hence, the quantitative dimension of globalization is often exaggerated.

The Economics of Fiscal Decentralization in Indonesia.

The prospects for national economic growth and development in today's Indonesia seem to hinge critically on the decisions that are taken with respect to economic activity at the level of local government.[5] Advocates of fiscal decentralization argue that devolution of fiscal powers to local governments tends to enhance efficiency: local governments are more accountable to their constituencies than is central government and local government is better informed about local conditions and demand for public goods and services (Oates 1972). Fiscal decentralization therefore should lead to a more efficient allocation of resources and is expected to be positively associated with growth in real GDP per capita of the country as a whole.[6]

Critics of fiscal decentralization have warned of the dangers of corruption among local officials and loss of macroeconomic balance, problems that cannot be taken lightly in the Indonesian context (Prud'homme 1995). In particular, with decentralization in Indonesia, concerns have been expressed over the propensity of local authorities to impose local taxes and restrictions on domestic trade, to restrict citizenship rights, and to adopt discriminatory policies towards businesses located outside the local jurisdiction (Goodpaster and Ray 2000). Excessive taxation of commerce between the regions and localities would be harmful to the national interest by increasing the cost of firms and individuals doing business, introducing further uncertainty in an already difficult investment environment, and by rendering Indonesian goods and services less competitive in foreign markets.

Indonesian Experience with Centralized Fiscal Authority.

In order to appreciate the strong desire at the local level in the regions for autonomy it is important to understand the history of treatment of the regions by the central government. In the past, the central government exercised both economic and political control over the outer islands from Jakarta. The central government, in effect extracted rents from the natural resource wealth in the regions and recycled these in order to maintain political power. In doing so, the central government had to make sure its political apparatus could disperse sufficient largesse to win the support it needed to stay in power.

[4] Anderson and Van Wincoop (2001) argue that McCallum's model is biased and that, properly specified, cross border trade flows are "only" 44% less than inter-provincial trade flows.
[5] For a useful discussion of the issues surrounding regional autonomy in Indonesia, see Nombo (2000).
[6] A study of China found a positive and statistically significant correlation between fiscal decentralization and growth in real GDP per capita between 1970 and 1993 (Lin and Liu 2000).

The provision of funds for regional development and local public goods from a central authority can also be seen as a way of addressing regional inequalities and consolidating national unity. The constitution clearly states that the natural wealth of Indonesia it for the benefit of all Indonesians and gives a rationale for the center to exercise central control over the nation's natural wealth. Article 33, line 3 of the 1945 constitution (Department of Information 1989) states: "*The land, the waters and the natural riches contained therein shall be controlled by the State and exploited to the greatest benefit of the people.*"

In the period of the 1950s the central government began a series of interventions that culminated in the seizure and nationalization of foreign enterprises and massive capital flight. The policy of exchange control and undisciplined fiscal and monetary policies sparked inflation and made it difficult to legally engage in foreign trade. This combination of policies and adverse economic consequences alienated some of the regions to the point of armed rebellion. In particular, nationalization of Dutch and other foreign-owned private enterprises including plantations producing rubber, palm oil and other export cash crops in 1957 led to a severe secular decline in export receipts and incomes in the regions. Roads, ports and other infrastructure essential to trade fell into a severe state of disrepair and neglect. Further aggravating the economic conditions facing villagers was the imposition of a ban on Chinese merchants engaging in retail trade in rural areas.

The breakdown of Indonesia's international trade deprived it of the scarce foreign exchange it needed for the import of rice and other foodstuffs. The problem was compounded by the collapse of domestic trade brought about by the decrepit infrastructure and the expulsion of the Chinese traders from the villages and rural towns. The chaos that resulted in the economy culminated with hyperinflation and default on external debt. Political conditions also became chaotic and resulted in massive unrest and violence in 1965-66 that ended only after the seizure of power in 1967 by General Suharto.

Under the "New Order" regime policies towards the regions were designed to ensure tight political control by the ruling party but also to foster economic development. In contrast to the previous government, the New Order used the fiscal windfall resulting from the oil boom to promote trade and economic activity throughout the country and made vast improvements in infrastructure required for domestic and international trade.

The economic record of the New Order in the regions is decidedly mixed.

There is little doubt that the attainment of national self-sufficiency in rice and the dramatic improvements in infrastructure, schooling, public health and nutrition have benefited the vast majority and drastically reduced poverty incidence, particularly in the countryside (Arndt 1996). No doubt these improvements have been associated with rising intra-regional trade. However, evaluation of the overall structure of trade taxes, subsidies and interventions indicates that there was a fairly strong bias against primary sector activities and in favor of manufacturing (Garcia-Garcia 2000). This bias in the overall policy regime meant that the terms of trade were stacked against the outlying islands and regions and also favored urban manufacturing centers on Java relative to the rest of the country. International trade deregulation lowered these biases but did not eliminate them. Export restrictions were imposed on a wide variety of primary goods, including rattan and logs (Sondakh 1996). Domestic trade in certain commodities (livestock) important to outer island farmers were restricted and in some cases, monopolized (cloves and oranges). Garcia-Garcia (2000) estimates that government trade and price interventions acted as a net tax on agricultural production of 50 percent in 1987 and 25 percent in 1995 and that this net taxation of agriculture through trade and price interventions lowered incomes in Eastern Indonesia, Bali, Sumatra and Kalimantan relative to Java.

And central control over local and provincial government prevented citizens of the outlying regions from enjoying free political expression and muted the development of civil society and local institutions. In restive regions, the government did not hesitate to use the armed forces to put down any resistance. In areas of thin population dominated by indigenous (non-Javanese) populations, an expansive transmigration program introduced ready-made vote banks for the central government.

<u>The Decentralization Movement and Domestic Trade</u>.

Decentralization and the local autonomy movements in the regions today are in an important sense a backlash against previous government's overly centralized control. With decentralization, it is predictable that regions and localities with valuable natural resources will demand a greater share of the resource rents. In all the regions one may expect local governments to demand to exercise more control over the use and disposal of local natural resources and assets. Decentralization and local fiscal autonomy, in theory, should bring about a more efficient match between demand and supply of public goods at the local level. However, it is critical that local governments adopt appropriate policies and fiscal instruments. Local taxation of property would normally be the main revenue source of local governments and, in the region's cities and provinces, sales and income taxes may also be appropriate. However, use of property taxes requires that land is properly titled and registered, that assessment of land and property value is accurate and that the legal system is capable of adjudicating disputes in a timely and objective fashion. Unfortunately this is clearly not the case.

What is clear from experience is that taxes on domestic trade, particularly those that discriminate against producers in other localities, are harmful to national economic welfare. In principle both domestic and international trade are equally important. The presumption of economics is that both international and domestic trade be open and free. The history of economic advance in the west provides strong evidence in support of this presumption. And this is highly relevant to today's deliberations on globalization and decentralization in Indonesia.

<u>Free and Open Trade Versus Trade Restrictions: the European Experience</u>.

Consider the situation in Europe in the period leading up to the 18th Century at the beginning of the Industrial Revolution. That the industrial revolution first took root in Britain is no accident. Despite the facts that it had a smaller population, less fertile soil and was separated by formidable bodies of water from neighboring countries, Britain, rather than France or Germany, became the seat of modern industry and was alone in the first rank of nations by the 19th Century.[7] Britain was also the intellectual beachhead for advocates of free and open international trade in the 18th and 19th centuries. The classical school of economists took the issue of free trade very seriously. David Ricardo and John Stuart Mill, following the lead of Adam Smith, established the foundations of the consensus for free trade in Britain.[8]

[7] If one doubts the formidability of the channel as a barrier, note that in neither of the great wars of the twentieth century was British soil invaded by the armies of Germany.

[8] In contrast to the intellectual consensus in Britain, in France and Germany, there was no such consensus (Irwin 1996) and economic arguments for protection such as the infant industry case were developed by List in Germany and Cournot in France.

In contrast, on the continent and elsewhere (e.g. in Japan and China), free trade was regarded with suspicion. The public debate over free trade doctrine, however, was beginning to tilt in favor of the classical school. Attempts at an intellectual counter-revolution against free trade were largely a failure and rested on peculiar assumptions.

One of the key ingredients in Britain's remarkable transformation during this period was the fact that internal commerce and movement of factors of production were largely free and unrestricted there but not in the major powers of the continent. Landes (1999) emphasizes the role of free internal commerce as an explanatory variable in Britain's success relative to the continental powers and, in particular, takes note of the many restrictions and taxes local jurisdictions within France and Germany placed on internal trade.[9] Internal restrictions on the free movement of persons, factors of production, and goods segmented local markets. This prevented businesses from taking advantage of economies of scale and also greatly limited specialization and efficiency in production. In Britain such restrictions were minimal and allowed industry to develop unimpeded, particularly after repeal of the Corn Laws restricting importation of grain.

In Asia, countries that have impeded the relatively free flow of commerce within their borders have lagged in growth and development. India is a good example of the negative impacts such domestic trade restrictions have on even a large, geographically contiguous country let alone in an archipelago like Indonesia. The deleterious economic effects of internal trade restrictions are bound to hinder industrial development and would pose a significant disadvantage to export production. In addition to harming export competitiveness, barriers to domestic commerce would inhibit the development of ancillary domestic production in support of exports.

Local authorities in Indonesia have been known to erect barriers to internal trade in order to extort money from legitimate trading activities. So-called third party contributions (SPK) have been documented in recent studies (Goodpaster and Ray 2000). Informal tolls are also found to exist at ports, weigh stations and entry points to towns and cities and these represent taxes on domestic trade that raise costs and harm consumers and producers. Such extortion of traders is also often discriminatory and targets products produced by other localities. Domestic trade taxes, particularly those applied on movement of agricultural products from remote rural areas are extremely harmful in that they make it more difficult for low-income farmers to benefit from distant urban markets in the country. Multiple taxation of such produce is clearly against the development of remote locations and may widen income disparities between regions. Such taxes on internal trade may also adversely affect supply of produce for export, if exporting requires internal movement or collection of produce from hinterlands to urban ports, which is often the case.

Public Choice Theory and Decentralization.

There may be some cause for cautious optimism as Indonesia gropes with the process of democratization and fiscal decentralization. Public choice—the application of economic principles to political science—has advanced the concept of "voting with one's feet"(exit) to examine the problems of a decentralized fiscal system under democracy. Local governments must compete with each other in order to attract business activity, private investment and citizens

[9] *Octroi* is a French term for customs barriers at the entrance of towns and cities. Proliferation of tolls on domestic trade that were unrelated to improvements in infrastructure were reflective of political weakness and general insecurity (Landes 1999: 245).

with skills that confer benefits to the community and to avoid the exit of existing businesses and skilled citizens. Hence jurisdictions ultimately are constrained in their behavior with regard to local taxation and public goods provision must be in line with local preferences. It is far from clear that such a rational outcome will be in the offing in a situation of general insecurity and political chaos, however.

A seminal article by Tiebout (1956) develops the notion of competition among local jurisdictions in a system where citizens may choose among jurisdictions. Tiebout choice has been shown to be effective in promoting improvements among public school districts in the United States (Hoxby 2000). Hence, in a stable democracy over the long haul one would expect local governments to compete with one another in attracting talented people, business and related trade and investment by offering quality public goods and a secure environment.

Conclusion.

If decentralization is to bring benefits to local jurisdictions in Indonesia, as it promises to match the supply and demand for local public goods more efficiently than can be done at the center, use of appropriate fiscal instruments will be critical. The deliberations of this conference will provide excellent input into the public discussion and debate regarding these instruments. The recommendation to allow free and open trade, movement of productive factors and persons within the country and to maintain open international trade with continued reduction in trade barriers is a first best solution. It is important to recognize that existing trade and price interventions are inimical to the interests of producers and consumers in the outer islands and act as a tax on incomes of agricultural producers. Hence, on-going trade liberalization acts as a policy to boost the prospects for development in the outer islands, particularly in rural communities.

Although it may be unrealistic to think that taxation of domestic trade by local authorities can be controlled and minimized, effort should still be devoted to keeping domestic trade flows free.

Local authorities have shown a predilection to impose arbitrary taxes on domestic trade and to impose fines or tolls on traders and transportation companies at various entry points, ports, weigh stations, etc. These taxes are unrelated to provision of public goods and services and are purely forms of rent-seeking behavior. Unfortunately, these domestic trade barriers have adverse affects on producers and consumers and may reduce the competitiveness of Indonesian products in external markets.[10] Not only do these barriers reduce economic efficiency, they are also likely to harm producers in remote and rural areas relative to those in Java and urban centers. The illegal collection of taxes on domestic trade may result from the lack of authority of local governments to use alternative, more appropriate revenue sources. In addition, enforcement of anti-corruption laws to punish officials who attempt to illegally tax trade will be necessary.[11]

Some form of revenue-sharing arrangement with the center that gives proper incentives to local government is essential as is the devolution of property taxation authority. More critical still will be reform of the civil service bureaucracy and investment in human resource development. The ability of civil servants in the regions to provide local public services critical to economic development at the street level will determine the success of decentralization.

[10] Determination of who bears the tax burden (the incidence of the tax) between producers and consumers depends on a complex set of price, income and substitution elasticities, as well as on the mobility of factors of production (Break 1974).

[11] Polinsky and Shavell (2000) discuss the use of fines and deterrence in the public enforcement of law.

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